

DEPARTMENT OF STATE REVENUE

**LETTER OF FINDINGS NUMBER: 02-0246
Unrelated Business Income Tax
For The Years Ending 1996 Through 2000**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

Adjusted Gross and Supplemental Net Income Tax – Unrelated Business Income

Authority: IC 35-45-5-3; IC 6-2.5-5-25; IC 6-2.1-3-23; IC 6-3-2-3.1(a); IC 6-3-1-17(a); IC 6-8.1-5-1; 45 IAC 3.1-1-68.

The taxpayer protests the classification of proceeds from illegal gambling machines as unrelated business income.

Tax Administration – Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-1 & 2

The taxpayer protests the Department's imposition of the ten percent (10%) negligence penalty.

STATEMENT OF FACTS

As a result of an Indiana Excise Police investigations and citations dated August 12, 1995 and June 29, 2000, the Taxpayer was cited for professional gambling under IC 35-45-5-3 and promotion of professional gambling under IC 35-45-5-4 respectively. The Department conducted an income tax audit based upon the Taxpayer's possession of five (5) illegal gambling machines discovered at its location.

The Taxpayer's representative admitted that the operation of the gaming machines was illegal for state law purposes. The taxpayer also received 60% of the proceeds from the machines for allowing and operating the machines at their facility.

Adjusted Gross and SNIT – Unrelated Business Income

DISCUSSION

Under Indiana Code section 35-45-5-3 the machines operated in taxpayer's establishment constitute illegal gambling. Proceeds from illegal gambling are considered unrelated business income and subject to Indiana gross or adjusted gross and supplemental net income tax.

IC 35-45-5-3 provides in pertinent part:

A person who knowingly or intentionally: ... (3) maintains, in a place accessible to the public slot machines, one-ball machines or variants thereof... commits professional gambling, a Class D felony.

The Department and the Internal Revenue Service have held that that illegal gambling is always unrelated to a tax exempt organization's exempt purpose. Exemption from tax for exempt organizations is tied to the gross income tax provisions with respect to exempt organizations. IC 6-2.5-5-25. As provided under IC 6-2.1-3-23, exempt organizations are not entitled to exemption from gross income received by a taxpayer that is derived from an unrelated trade or business, as defined in Section 513 of the Internal Revenue Code. Thus, the Department's determination was guided by I.R.C. § 513, which provides, in part, the following:

...The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Pursuant to IC 6-3-2-3.1(a) and IC 6-3-1-17(a), the Indiana General Assembly has expressly adopted the Code's tax treatment, with respect to Code section 501(c) organizations, for purposes of the Indiana adjusted gross and supplemental income tax analysis. Moreover, the Department's rule 45 IAC 3.1-1-68 defines an unrelated trade or business under the same guidelines as IRC section 513, and the rule also subjects any unrelated business income to the Indiana taxes. Additionally, the rule cites taxpayers to Code sections 511 through 515 for guidance in determining whether income is subject to the taxes.

Pursuant to IC 6-8.1-5-1 if the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department. The proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.

The taxpayer's representative argues that only their members are allowed to use the gambling machines and that all of the money should have been classified as related business income. The taxpayer contends that it is a fraternal organization organized for social purposes and that

the machines are played for social purposes and are a vital part of its receipts used to operate its facility. The taxpayer's representative contends that they had an audit by the Internal Revenue Service in which the federal auditor told the organization that gambling proceeds from its machines is related business income. The Department doubts the validity of IRS auditor's alleged statement. If the taxpayer was established to overtly conduct illegal activities then the income could be classified as related. The use of illegal gambling machines is also grounds for the IRS and State of Indiana to revoke taxpayer's not-for-profit status.

FINDING

The taxpayer's protest is denied.

II. Tax Administration - Liability for 10% Negligence Penalty

DISCUSSION

The taxpayer protests the Department's imposition of the ten percent (10%) penalty assessment. Indiana Code section 6-8.1-10-2.1 requires a ten percent (10%) penalty to be imposed if the tax deficiency is due to the negligence of the taxpayer. Department regulation 45 IAC 15-11-2 provides guidance in determining if the taxpayer was negligent. 45 IAC 15-11-1(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is also to be determined on a case-by-case basis according to the facts and circumstances of each taxpayer.

Subsection (d) of IC 6-8.1-10-2.1 allows the penalty to be waived upon a showing that the failure to pay the deficiency was due to reasonable cause. Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish reasonable cause, the taxpayer must show that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed. . . ."

In this instance, the taxpayer has shown reasonable cause. The taxpayer has provided to the Department's satisfaction, sufficient justification for why the negligence penalty should be waived.

FINDING

The taxpayer's protest is sustained.